SKY'S RESPONSE TO OFCOM'S 2018 'BUSINESS CONNECTIVITY MARKET REVIEW'

EXECUTIVE SUMMARY

1. Ofcom considers that promoting effective and sustainable infrastructure competition through duct and pole access ("DPA") and dark fibre access ("DFA") remedies has the potential to deliver significant dynamic efficiencies and, hence, material downstream benefits to businesses and consumers. It argues that these remedies could allow competition to emerge more strongly and at a faster rate and provide greater flexibility to communications providers ("CPs") looking to invest in new network infrastructure.

2. In particular, Ofcom is proposing to require BT to provide DPA and DFA based products because it considers that this will improve the investment case for alternative networks by reducing the inefficient duplication of passive network components. In relation to the DFA remedy, Ofcom considers that BT should make dark fibre available at BT local exchanges where no other Principal Core Operators ("PCOs") are present ("BT Only" exchanges) because it is not economically viable for PCOs to connect to these exchanges by using DPA or building directly themselves.

3. Further, Ofcom aims to promote infrastructure competition while also protecting downstream competition and, hence, businesses and consumers from BT's significant market power ("SMP"). To achieve this, Ofcom must be evidence-led and maintain strong and targeted SMP regulation until effective and sustainable competition has materialised.

4. We consider that there are two elements of Ofcom's proposals that are unlikely to achieve these objectives.

5. First, Ofcom's proposed inter-exchange DFA remedy is too narrow by being limited to BT Only exchanges. It is almost as unviable for PCOs to use DPA (or build directly) to "BT+1" exchanges (where one other PCO is present) as it is to BT Only exchanges. On Ofcom's own terms, the conditions are sufficiently similar to justify the extension of the DFA remedy to BT+1 exchanges.

6. Second, Ofcom's proposed downstream leased line charge controls should be lower and more cost-based. Ofcom justifies its approach on the basis that maintaining above-cost prices will facilitate infrastructure-based market entry. However, viable and sustainable entry will be predicated on long term, post-entry pricing, which will be more cost reflective in response to the increase in competition. There is a danger therefore that Ofcom's approach would harm downstream competition, business and consumers unnecessarily.

7. In addition to these concerns, there is a material risk that Ofcom's proposed remedies will not be in place when the current temporary SMP conditions expire and that businesses and consumers will be harmed during the ensuing lacuna. It is essential that Ofcom acts now to ensure that appropriate temporary arrangements – including a constraint on BT's charges – are in place to ensure that BT is not able to leverage its SMP unduly after the current conditions expire.

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Ofcom's inter-exchange DFA remedy should be applied to both BT Only and BT+1 exchanges

8. Sky's demand for backhaul from BT's local exchanges continues to grow as its broadband customers continue to consume more data. As opposed to persisting with purchasing multiple high capacity leased lines at each exchange to meet this growing demand – which is inefficient – Sky is reconfiguring its metro (local exchange to core) network to utilise optical networks where additional capacity is provided by adding wavelengths to a fibre circuit. Inter-exchange DFA will enable Sky to increase its backhaul capacity more efficiently (via additional wavelengths) at more BT local exchanges than it could otherwise.

9. Ofcom is proposing to require BT to offer DFA to BT Only exchanges because it would be economically unviable for PCOs to connect to these exchanges by any other method – such as DPA or building directly themselves. In short, the costs of connecting via other methods are too high for the relatively lower value of these circuits to PCOs.

10. While we consider that these conditions apply almost equally to BT+1 exchanges, Ofcom does not propose to require DFA to be offered to these exchanges because it considers there is a "*a potential risk of deterring rival network operators from connecting to BT+1 exchanges and developing their backhaul networks, especially following the introduction of our proposed unrestricted duct access remedy*".[1]

11. While Ofcom's conclusion does not appear to be based on any clear evidence of the appropriate threshold for a PCO to connect a BT+1 exchange via DPA rather than to buy active circuits from BT, our analysis of Ofcom's 'Break-even distance estimation cost model' [2] suggests that it has underestimated the likely costs of using DPA to connect to BT+1 exchanges and overestimated the value of circuits in these areas to PCOs. If Ofcom were to adjust its cost and value estimations appropriately, it would become apparent that using DPA to connect to BT+1 exchanges is less viable than Ofcom currently considers and that, on Ofcom's own terms, extending the DFA remedy to these exchange areas is justified.

<u>The costs of connecting BT+1 exchanges via DPA are likely to be higher than modelled by Ofcom</u>

12. One of the main outputs of Ofcom's model is to 'goal seek' the economic break-even distance for connecting new exchanges to a PCO's network. Of the scenarios in Ofcom's model, we note that 2b is closest to a PCO connecting an exchange using DPA (i.e. new blown fibre tube and fibre cable, but no new duct required). There are two issues with Ofcom's cost modelling:

    (a) the assumed costs for installing a new blown fibre tube and fibre cable (£5.57 per metre in total) are significantly lower than we expect (our internal estimate is that the total cost is likely to be closer to £[redacted] per metre). This is because Ofcom has used Openreach's Excess Construction Charges as the relevant benchmark cost[3] but PCOs' equivalent costs are likely to be significantly higher as they have far lower economies of scale compared to Openreach; and

1 Paragraph 12.97, Ofcom "Business connectivity market review – Volume 1: Market analysis, proposed SMP findings and remedies" (Consultation, November 2018). ("**BCMR consultation**").

2 Annex 16, BCMR consultation.

3 Footnote 76, Vol 1 – BCMR consultation.

(b) in a DPA scenario there would be additional capex (£2,000 for an external cablelink) and opex (duct and ancillaries rentals).

Ofcom's circuit value estimates are likely to be too high

13. Ofcom suggests that demand for backhaul in BT+1 areas is likely to be higher than BT Only areas with more demand for higher bandwidths. Ofcom argues that this means that the value of circuits in BT+1 areas will be higher and "*it is possible that as demand for backhaul and bandwidth increases some PCOs might connect to some* [BT+1] *exchanges over the medium to longer term, particularly given our proposals for unrestricted DPA.*" [4]

14. Ofcom provides no evidence to support this and states that the likelihood of network build "*remains uncertain at this time*" and that Ofcom will "*review the mix of … remedies as investment plans materialise.*" [5]

15. However, the approximately 700 exchanges that Ofcom proposes to classify as BT+1 are generally located in areas where demand for leased lines is likely to be very limited. Moreover, Ofcom's model assumes that rental revenue stays constant over the period (7 years) but this fails to take account of: (i) general price attrition in the very high bandwidth ("VHB") leased lines market that would stem from competition and efficiencies; and (ii) the fact that any new competitor is likely to have to offer significant discounts in order to win new business. The assumed net present value of circuits in BT+1 exchange areas is therefore likely to be too high.

Ofcom should extend the remedy to BT+1 areas

16. Taking appropriate account of all of these factors indicates that the economic break-even distances are far lower than Ofcom assumes and that increased competition at BT+1 exchanges is much less viable. Therefore, by Ofcom's own terms it should consider again extending the inter-exchange DFA remedy to BT+1 areas.

17. Finally, Ofcom's timeline for requiring BT to implement inter-exchange DFA quickly (within one month of the BCMR statement) is likely to be proportionate. This is because BT would have already completed much of the necessary product development back in 2017 when the DFA product release was stopped only one month prior to its planned launch date. Given the short timeframe of this market review, introducing the remedy quickly is desirable.

Ofcom's proposed downstream price controls are too high, allowing BT to make excess returns without having a material beneficial impact on investment

18. During this market review period and beyond, CPs will continue to rely heavily on downstream active business connectivity and backhaul services – Ofcom acknowledges that it remains necessary to maintain appropriately targeted SMP regulation of BT's supply of these services.

19. However, Ofcom's proposal to impose a charge control at Openreach's current prices for 1 Gbit/s and below leased lines and to introduce a safeguard price cap for VHB leased lines will allow BT to make excessive returns. Ofcom argues that this approach strikes the right balance between promoting investment and entry by competing networks and protecting downstream competition, business and consumers from excessive prices.[6] However,

4 Paragraph 12.87, Vol 1 – BCMR consultation.

5 Paragraph 12.89, Vol 1 – BCMR consultation.

6 Paragraphs 13.44-13.46, Vol 1 – BCMR consultation.

sustainable viable entry is predicated on long-term business cases which depend on post-entry prices, which will be more cost-reflective as network competition increases. As such, maintaining higher prices risks harming competition and end users without any discernible beneficial impact on investment and market entry.

20. Ofcom accepts that its proposed downstream price controls will allow BT to make excessive returns and result in large static efficiency losses. For example:

(a) in relation to its proposal to cap charges in nominal terms for 1 Gbit/s and below leased lines, Ofcom acknowledges that BT could be expected to recover around £50m to £65m more over the market review period than if it set the price control on a fully allocated cost basis and by up to £135m if it adopted a cost-based CPI-X control, meaning that Openreach's charges will be 30% to 40% above cost by the end of the market review period; and

(b) Ofcom fails to model the potential welfare loss that will result from not adopting a cost-based price control for VHB services but observes that "*VHB prices are currently significantly above cost*" [7] and forecasts that volumes are likely to rise significantly over the market review period.[8]

21. Ofcom makes no attempt to quantify the dynamic efficiency gains that may flow from new investment and, instead, asserts that "*any potential over-recovery of costs by BT will* [not] *outweigh the benefits of pricing stability* [from its proposed approach]" [9] and that it needs to "[strike] *the right balance between protecting consumers from high prices (while allowing BT the opportunity to recover its efficiently incurred costs) and providing certainty and stability as we transition to the introduction of new, long-term downstream regulation for business and residential markets*." [10]

22. However, Ofcom's downstream charge controls will have little impact on investment and pre-emptive reductions in charges now are unlikely to deter entry. What matters for the profitability of a new entrant is the prices that would arise from competition post-entry. These can be expected to be lower than Ofcom's proposed charge controls as increased competition would drive them towards costs.

23. Therefore, it is not necessary for Ofcom's charge controls to be so high. It can still strike the right balance between investment and entry on the one hand and protecting downstream competition and consumers on the other by introducing cost-based (CPI-X) charge controls for both 1 Gbit/s and below and VHB services.

Ofcom needs to take steps now to minimise the likelihood of a lacuna occurring in the future

24. Sky is concerned that Ofcom's proposal to publish its decision in spring 2019 may result in a regulatory lacuna, given that the current temporary conditions expire in March 2019.

25. This presents a significant risk to Sky and other CPs. In this case, all of the SMP conditions on BT would fall away – not just the charge controls as in previous lacunae. Lacunae generally represent a considerable risk to Sky but the lapsing of all SMP conditions heightens that risk. In particular, there would not be the safeguard that, in the absence of a charge control, BT must offer services on fair and reasonable, and non-discriminatory

[7] Paragraph 2.18, Vol 2 – BCMR consultation.

[8] Paragraph A18.45, Annexes – BCMR consultation.

[9] Paragraph 2.14, Vol 2 – BCMR consultation.

[10] Paragraph 2.13, Vol 2 – BCMR consultation.

terms and conditions (including charges). While Sky does not consider this to be an adequate protection, it is better than nothing. Further, during previous lacunae, Ofcom has argued that its presence makes it unnecessary for further steps to be taken to reduce the risk of harm.

26. To resolve this issue, we request that Ofcom extends the current temporary SMP conditions[11] to cover any lacuna period. In any event, we request that Ofcom provides full transparency on any plans and discussions with BT in relation to the lacuna and that it confirms what proposals and arrangements it intends to put in place.

Sky **January 2019**

[11] Ofcom "Business Connectivity Markets: Temporary SMP conditions in relation to business connectivity services" (November 2017).